Supreme Court, U. S.
FILED
DEC 18 1980
MICHAEL RODAK, JR., CLER

80-1000

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1980

No._____

SAMUEL G. PAYTE, *Petitioner*

v.

UNITED STATES OF AMERICA, *Respondent*

Petition for Writ of Certiorari to the United States Supreme Court from the United States Court of Appeals for the Fifth Circuit

DANIEL L. PENNER
Counsel for Petitioner

PENNER & JONES
1400 Fort Worth National Bank Bldg.
Fort Worth, Texas 76102

Fort Worth Brief Printing Co., 610 S. Jennings Street, 332-4070, 336-4524

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1980

No._____

SAMUEL G. PAYTE, *Petitioner*

v.

UNITED STATES OF AMERICA, *Respondent*

Petition for Writ of Certiorari to the United States Supreme Court from the United States Court of Appeals for the Fifth Circuit

---

QUESTION PRESENTED

Whether the District Court and the Fifth Circuit Court of Appeals erred in holding that interest paid by Taxpayer (Petitioner) on a promissory note, the proceeds of which were paid to a deceased business partner's estate for the purchase of his partnership interest by the surviving partners, was not attributable to Taxpayer's (Petitioner's) trade or business, within the meaning of I.R.C. §172(d)(4), and therefore not eligible for loss carryback treatment to offset Taxpayer's (Petitioner's) business income of the carryback year.

TABLE OF CONTENTS

Page

Question Presented i

Table of Authorities iii

Opinions Below 1

Jurisdiction 1

Statutes Involved 1

Statement

- Course of Proceedings and Disposition In The Courts Below 3
- Statement of Facts 5

Argument 8

Prayer 21

Appendix

- Per Curiam Opinion of Fifth Circuit Court of Appeals 22
- Memorandum Opinion of the District Court 24
- Judgment Sought to be Reviewed 32
- Judgment of District Court 33

TABLE OF AUTHORITIES

Cases: *Page*

Axelrod v. Commissioner, 320 F.2d 327 (6th Cir. 1963) 8, 9, 12, 15, 20

Five Star Manufacturing Corp. v. Commissioner, 355 F.2d 724 (5th Cir. 1966) 13, 20

Harding v. United States, 113 F.Supp. 461 (Ct. Cl. 1953) 12, 14, 16, 20

Robert E. Imel, 61 T.C. 318 (1973) 11

Payte v. United States, 626 F.2d 400 (5th Cir. 1980) 8

Tompkins v. United States, 461 F.2d 1304 (Ct. Cl. 1972) 17-18

United States v. Generes, 405 U.S. 93 (1972) 16, 19

United States v. Smith, 418 F.2d 589 (5th Cir. 1969) 13, 20

Jim Walter Corp. v. United States, 498 F.2d 631 (5th Cir. 1974) 8, 12, 13, 20

STATUTES:

26 U.S.C. §162 ..... 1, 13, 14
26 U.S.C. §163 ..... 2, 14, 18
26 U.S.C. §166 ..... 2, 14, 16, 18, 19
26 U.S.C. §172 ..... 3, 7
26 U.S.C. §172(d)(4) ..... i, 3, 5, 7, 8, 13, 14, 16, 17, 18, 19
26 U.S.C. §701 15
28 U.S.C. §1291 5
28 U.S.C. §1331 5
28 U.S.C. §2101(c) 1

OPINIONS BELOW

The Memorandum Opinion of the United States District Court for the Northern District of Texas is reported at 492 F.Supp. 518 (N.D.Tex. 1979). The Per Curiam Opinion of the United States Court of Appeals for the Fifth Circuit is reported at 626 F.2d 400 (5th Cir. 1980). A copy of the Memorandum Opinion of the District Court and the Per Curiam Opinion of the Fifth Circuit are appended to this Petition in the Appendix at page 23 and page 22, respectively.

JURISDICTION

The judgment of the United States Court of Appeals for the Fifth Circuit was made and entered on September 24, 1980, and a copy thereof is appended to this Petition in the Appendix at page 29. The jurisdiction of this Court is invoked under 28 U.S.C. §2101(c). Petitioner's request for the Court's consideration of this Petition is based upon a conflict between the Fifth and Sixth Circuit Courts of Appeal on this issue.

STATUTES INVOLVED

The following Sections of the Internal Revenue Code of 1954, as amended, provide, in pertinent part:

SEC. 162. TRADE OR BUSINESS EXPENSES:

(a) In General. — There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. . . .

SEC. 163. INTEREST.

(a) General Rule. — There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

SEC. 166. BAD DEBTS.

(a) General Rule. —

(1) Wholly worthless debts.—There shall be allowed as deduction any debt which becomes worthless within the taxable year.

* * * *

(d) Nonbusiness Debts. —

(1) General rule. — In the case of a taxpayer other than a corporation—

(A) subsections (a) and (c) shall not apply to any nonbusiness debt; and

(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 9 months.

(2) Nonbusiness debt defined. — For purposes of a paragraph (1), the term "nonbusiness debt" means a debt other than —

(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

SEC. 172. NET OPERATING LOSS DEDUCTIONS.

(a) Deduction Allowed. — There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year. For purposes of this subtitle, the term "net operating loss deduction" means the deduction allowed by this subsection.

(c) Net Operating Loss Defined.— For purposes of this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income. Such excess shall be computed with the modifications specified in subsection (d).

* * * *

(d) Modifications. — The modifications referred to in this section are as follows:

* * * *

(4) Nonbusiness deductions of taxpayers other than corporations — In the case of a taxpayer other than a corporation, the deductions allowable by this chapter which are not attributable to a taxpayer's trade or business shall be allowed only to the extent of the amount of the gross income not derived from such trade or business.

* * * *

The following Sections of the Internal Revenue Code of 1939 provided, in pertinent part:

Int. Rev. Code of 1939, ch. 1, §122 (now I.R.C. §172 (d)(4)):

§122. Net operating loss deduction

(a) Definition of net operating loss. As used in this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d).

* * * *

(d) Exceptions, additions, and limitations. The exceptions, additions, and limitations referred to in subsection (a), (b) and (c) shall be as follows:

* * * *

(5) Deductions otherwise allowed by law not attributable to the operation of a trade or business regularly carried on by the taxpayer shall (in the case of a taxpayer other than a corporation) be allowed only to the extent of the amount of the gross income not derived from such trade or business.

STATEMENT

Course Of Proceedings And Disposition In The Court Below

Petitioner, Samuel G. Payte, the Taxpayer herein, instituted this action to recover income taxes of Sixteen Thousand Five Hundred Forty-Six and 90/100 Dollars ($16,546.90) plus interest of Three Thousand Two Hundred Forty-Two and 97/100 Dollars ($3,242.97) and penalty of Nine Hundred Eighteen and 13/100 Dollars ($918.13), which was erroneously assessed and collected by the Internal Revenue Service for the calendar year 1968. The jurisdiction of the

District Court, the Court of first instance, was properly predicated on 28 U.S.C. §1331, federal guestion jurisdiction. The case was heard in the District Court on cross motions for summary judgment submitted to the Court in January, 1977. Two years later, on January 8, 1979, the United States District Court for the Northern District of Texas, Fort Worth Division, The Honorable Eldon B. Mahon, handed its Memorandum Opinion and Judgment which held that the interest expense was not attributable to Petitioner's trade or business within the meaning of I.R.C. §172 (d)(4). Taxpayer filed his Notice of Appeal on February 6, 1979. The jurisdiction of the Fifth Circuit Court of Appeals was conferred by 28 U.S.C. §1291. The Court heard the oral argument of counsel on June 11, 1980. On September 24, 1980, the United States Court of Appeals for the Fifth Circuit in a Memorandum Opinion affirmed the decision of the District Court. Petitioner, by this Petition, now seeks review in the Supreme Court of the United States, because of a conflict among the circuits as to the applicable law.

Statement Of Facts

The facts in this case are not in dispute. Petitioner, Samuel G. Payte, was involved in two business partnerships with E. L. Baker and Irwin Krauss which dealt in the development of commercial and residential real property. In 1968, Petitioner and his two business partners executed an agreement among themselves providing, *inter alia*, that in the event of the death of one of the partners, the two surviving part-

ners would purchase the deceased partner's interest. The terms of this 1968 agreement among the partners provided for a down payment of ten percent (10%) of the value of the deceased partner's interest and the execution of a six-year promissory note for the balance. The note was to bear interest at the rate of four percent (4%) per year and was to be secured by property belonging to the joint venture. Record at 81.

The 1968 agreement was entered into to provide a smooth transition of ownership, to avoid automatic termination of the partnership, and attendant forced sale, and so that the family or heirs of a deceased partner would not become involved in the actual business operations of the partnership. As such, the trial Court made a specific finding that the agreement was based upon business considerations. *Payte v. United States*, 492 F.Supp. 518, 519, 521 (N.D.Tex. 1979). Record at 83 and 86 (Memo. Op. *infra*, p. 31).

In November, 1969, E. L. Baker, a partner, died. Petitioner and Irwin Krauss, as surviving partners, appraised the value of the deceased partner's interest at $1,364,336.92. In accordance with the 1968 agreement, Petitioner and Krauss made a cash payment of $136,426.92 and in February, 1970, executed a six year promissory note for $1,227,900.00 at four percent (4%) interest per annum on the unpaid balance. The note was made payable to the Fort Worth National Bank, Trustee for the Estate of E.L. Baker. Record at 81.

In 1971, Petitioner paid the Fort Worth National Bank, as Trustee for the Estate of the deceased part-

ner the sum of $83,464.00 of which $24,038.64 was interest on the promissory note. Record at 82.

Subsequently on his 1971 Income Tax Return, Petitioner claimed the interest expense as an itemized deduction. The interest expense was treated on his return as being attributable to his trade or business under I.R.C. §172(d)(4). As allowed by I.R.C. §172, the interest deduction was carried back to offset Petitioner's 1968 tax liability for business income. Based on this 1971 carryback to 1968, Petitioner, in 1972, received a refund from the Internal Revenue Service of Sixteen Thousand Eight Hundred Thirteen and 61/100 Dollars ($16,813.61) plus interest of Five Hundred Sixty-Seven and 67/100 Dollars ($567.67). Record at 82.

Subsequently, in 1975, only a few days before the expiration of the statute of limitations and without statutory notice of assessment, Petitioner was assessed a tax liability for 1968 of Sixteen Thousand Five Hundred Forty-Six and 90/100 Dollars ($16,546.90), with additional interest of Three Thousand Two Hundred Forty-Two and 97/100 Dollars ($3,242.97) and a penalty of Nine Hundred Eighteen and 13/100 Dollars ($918.13). It is this sum of Twenty Thousand Seven Hundred Eight Dollars ($20,708.00) which Petitioner paid, which is in controversy in this action. Record at 82.

ARGUMENT

The essence of Petitioner's argument is that the interest expense herein involved is attributable to Petitioner's trade or business within the meaning of I.R.C. §172(d)(4), was properly claimed as an itemized deduction on Schedule A of Petitioner's 1971 Income Tax Return, and that the respective findings by the District Court and Fifth Circuit Court of Appeals disallowing the deduction and claim for refund was error. A conflict exists in the law between the Fifth Circuit and the Sixth Circuit regarding whether an interest expense deduction such as the one herein involved is allowable, and this conflict has been perpetuated by the Fifth Circuit's affirmance in *Payte v. United States*, 626 F.2d (5th Cir. 1980). A case decided by the Sixth Circuit, *Axelrod v. Commissioner*, 320 F.2d 327 (6th Cir. 1963), involved a situation virtually identical to that of Petitioner, and therein the Court held the interest expense deduction allowable. However, the Fifth Circuit Court of Appeals as well as the District Court followed a case urged by the Government and decided by the Fifth Circuit, *Jim Walter Corp. v. United States*, 498 F.2d 631 (5th Cir. 1974), which disallowed an interest expense deduction, and which is distinguishable in many respects from the case of Petitioner.

In *Axelrod v. Commissioner*, 320 F.2d 327 (6th Cir. 1963), a case closely analogous to Petitioners, the Court stated (at p.329):

> We do not consider the acquisition of a capital interest in a going *non-corporate* business in order

> to preserve its existence as reflecting business relationships any less than acquisition of assets for inventory or of property for the production of income. If proceeds of a loan find a proximate route into the borrower's trade or business, whether as the means for the purchase of a further capital interest in the *non-corporate* borrower's going business to effect its preservation or for the purchase of a fixture, the fact that "business relationships" as opposed to "personal relationships" caused the incurrance of the obligation suffices to bring the guarantor within this section upon his payment of the obligation. Whether the proceeds were used to commence, sustain, or sever a business relationship, the common denominator of these situations is "business relationship," the existence of which always precedes a severence thereof. [Emphasis supplied]

The Court in *Axelrod* was referring to a situation almost identical to that of Petitioner's. In both cases, the remaining partner or partners in the partnership were forced to buy out the other partner's interest in the partnership in order to preserve the existence of the partnership. The Court in *Axelrod* permitted the deduction finding a business relationship for the loan, based upon the fact that the proceeds were used to preserve the partnership.

Petitioner in this cause of action seeks to deduct the interest expense incurred in conjunction with a loan, the proceeds of which were used to purchase the partnership interest of Mr. Baker who had died in 1969. Petitioner's reasons for entering into the Buy-

Sell Agreement pursuant to which the purchase was made were:

1. *To protect his business reputation.* The partners were personally liable on indebtness which, at the time the Buy-Sell Agreement was executed by the partners, exceeded the value of the assets of the partnership under forced sale condition. (Payte Dep. P. 35, L. 12-22, P. 36, L. 25, P. 37, L. 1-2). The excess of liabilities over assets was certain in the event of forced sale of the partnership assets. A forced sale would have resulted in the event of a partner's death with no agreement to the contrary between the partners. Petitioner felt it was absolutely necessary to pay off the many and substantial liabilities of the partnership in order to be able to continue in business in any form in the future. (Payte Dep. P. 17, L. 20-25, P. 18, L. 1-6, P. 43, L. 10-25, P. 44, L. 1-5).

2. *To protect his income.* In the event of a forced sale, the survivors would have sold the partnership assets for less than the indebtedness thereon in order to liquidate the partnership. In such event, Petitioner, who devoted most of his time to and derived a substantial portion of his income from the partnership (Payte Dep. P. 12, L. 6-8, P. 31, L. 7-9) would have, in effect, lost his job together with a substantial portion of his income.

3. *To provide for an orderly continuation of the business.* It was considered by the partners that E. L. Baker was older and would probably be the first of the partners to die. It would have been most disruptive for the surviving partners to deal with the surviving

heirs of E. L. Baker. Petitioner testified that "under no circumstances did we feel that we could survive" dealing with the heirs of E. L. Baker (Payte Dep. P. 15, L. 3-4).

The critical element in the *Axelrod* holding is the fact that the loan proceeds were used to *increase* a capital interest in a going non-corporate business in order to *preserve* its existence, as opposed to loan proceeds being used to *acquire* an interest in a business in which the borrower previously had not owned any interest. *Robert E. Imel*, 61 T.C. 318 (1973).

Throughout the proceedings the lower courts obviously considered that there was no substantial difference between a new partner buying into the firm, and an existing partner buying out another partner. In either case, according to the District Court, the acquisition of the partnership interest is an investment as opposed to an ongoing trade or business expense. It is abundantly clear to Petitioner that there is a significant difference between the two where, as in the instant case, the Petitioner entered into the Buy-Sell Agreement in order to (1) prevent a forced sale of partnership assets, (2) protect income, (3) maintain the surviving partners' business reputations by paying off the partnership indebtedness on which they were both personally liable, and (4) avoid a most disruptive business situation caused by the survivors being required to be partners in the liquidation with a deceased partner's heirs.

The lower Courts took the position that there was no substantial difference between a partner and a

partnership, on the one hand, and a shareholder and a corporation, on the other, insofar as this case is concerned. Petitioner continues to submit that the difference is both readily apparent and necessarily made in this case. Respondent and the lower Courts ignored the very basic legal theory that the trade or business of a partner is that of the partnership. *See e.g., Harding v. United States*, 113 F.Supp. 461, 463 (Ct. Cl. 1953). In the case at bar, Petitioner's business was that of the partnership. The partnership's livelihood as well as Petitioner's livelihood was threatened with extinction by the immediate liquidation of the partnership by forced sale of its assets if there were no Buy-Sell Agreement which provided for the orderly transition of a deceased partner's interest to the surviving partners. Such would not have been the case if the business had been incorporated, since liquidation would not have been necessary under local law absent an agreement to the contrary.

The District Court and the Fifth Circuit both placed great weight upon the case of *Jim Walter Corp. v. United States*, 498 F.2d 631 (5th Cir. 1974). While the Petitioner insists that *Axelrod* is controlling precedent here for the reason that *Axelrod* deals with the acquisition of an increased partnership interest in a non-corporate business, and *Jim Walter Corp.* deals with the acquisition of warrants in a corporate setting, even assuming *arguendo*, that *Jim Walter Corp.* is to be considered, and the origin of the loan governs, the origin of the loan was clearly *not* to make an investment. Petitioner already had an investment

in the partnership and his acquisition of the increased interest in the partnership was merely to save an ongoing business (*his* trade or business) from liquidation and forced sale caused by precisely the tragedy which occurred, i.e. the death of E. L. Baker. Petitioner's investment in the partnership was already made prior to his entering into the Buy-Sell Agreement. The entering into the Buy-Sell Agreement was for the business reasons stated above, and Petitioner's implementation of the Agreement upon the death of Baker merely had, as an incidental result, the increase in his percentage ownership of the partnership.

In analyzing this case, the District Court and the Fifth Circuit plainly and simply misapplied the law. Relying heavily on *Jim Walter Corp. v. United States*, 498 F.2d 631 (5th Cir. 1974), as that case distinguished *Five Star Manufacturing Corp. v. Commissioner*, 355 F.2d 724 (5th Cir. 1966) and *United States v. Smith*, 418 F.2d 589 (5th Cir. 1969), both Courts ruled effectively that unless an expenditure qualifies as a deduction under I.R.C. §162, it will not qualify as attributable to Petitioner's trade or business under §172(d)(4).[1] Petitioner never contended that the interest payments in question qualify as deductions under §162. The language of §162 requires a relation to the "operation" or "carrying on" of the business. For this reason, the payments were deducted on Schedule A, Itemized Deductions, rather than Schedule C, Profit and Loss from Business or Profession, of Petitioner's 1971 Income Tax Return.

[1]I.R.C. §172(d)(4) (hereinafter, unless otherwise indicated, all citations to Section numbers, as indicated by "§", refer to sections of the Internal Revenue Code of 1954, as amended.)

For purposes of the first test of §172(d)(4), it is irrelevant that the interest expenditures were not deductible under §162, because they were deductible under §163. Although the purchase price itself and the interest thereon are "attributable to the taxpayer's trade or business," Petitioner makes no contention that either it is or was "an ordinary or necessary expense paid or incurred . . . in carrying on any trade or business. . . ." I.R.C. §162. Because the interest was deductable under §163 and because it and the principal payments were attributable to the trade or business of the Petitioner, the interest qualifies as a business deduction under §172(d)(4).

In the final analysis, there is no authority for the proposition that an expenditure must qualify under §162 in order to qualify under §172(d)(4), although it is certainly true that qualification under §162 will qualify the expenditure under §172(d)(4), *Cf.*, *Harding v. United States*, 113 F.Supp. 461 (Ct. Cl. 1953) (commenting that qualification under §166 should require qualification under §172(d)(4)). The reason for this conclusion is simply that §172(d)(4) imposes a much looser test than §162, or, in mathematical terms, the §162 set of deductions is a subset of the §172(d)(4) business deductions.

In addition to confusing the application of expenses "attributable to" a trade or business and "incurred . . . in carrying on" a trade or business, the lower Courts have totally misunderstood the motivational approach to deductibility under §172(d)(4). The District Court ruled, and the Fifth Circuit affirmed, in

effect, that Petitioner's motivation was irrelevant, even though, as stated in *Axelrod v. Commissioner*, 320 F.2d at 329, the law does:

> . . . not consider the acquisition of a capital interest in a going non-corporate business *in order* to preserve its existence as reflecting business relationships any less than acquisition of assets for inventory or of property for the production of income. If proceeds of a loan find a proximate route into the borrower's trade or business, whether as the means for the purchase of a further capital interest in the non-corporate borrower's going business to effect its preservation or for the purchase of a fixture, that fact that "business relationships" as opposed to "personal relationships" *caused* the incurrence of the obligation suffices to bring the guarantor within this section upon his payment of the obligation. [Emphasis added]

The emphasized portion of the above quoted passage illustrates the importance of motivation or cause, as opposed to the mere existence of a business emergency.

The key to the above quoted excerpt from *Axelrod* is the fact that it relates to a non-corporate business as opposed to a corporate business. For federal income tax purposes, the partnership is not treated as a separate entity and is not of itself taxable. §701. A partner's interest in a partnership is subject to many more statutory and contractual limitations on transfer than is a corporation. To contend that a general partner holds his partnership interest, with all the contingent liability attached thereto, in the same manner and

for the same investment opportunities as a shareholder in a corporation is to discount the elemental difference between corporations and partnerships. This objective criteria serves well to distinguish Petitioner from the employee-shareholder taxpayer in *United States v. Generes*, 405 U.S. 93 (1972).

Petitioner submits that motivation is relevant and that both the District Court and the Fifh Circuit Court of Appeals erred in failing to apply the "significant motivation" approach in Petitioner's case, a standard which already has support with regard to §172(d)(4). Petitioner further submits that such section would be properly represented on the facts of this case by the "significant motivation" approach, which the Fifth Circuit imposed with respect to business versus non-business bad debts prior to the Supreme Court's holding in *United States v. Generes*, 405 U.S. 93 (1972) *rev'g*, 427 F.2d. 279 (5th Cir. 1970). Petitioner urges that this approach is still viable in the bad debt area with respect to non-employee-shareholders, see discussion p. 18, 19 *infra*, and would be appropriately imposed on §172(d)(4) even if it were not viable under §166. Under this test, the question is whether Petitioner's business motivation in making the expenditure was significant.

The appropriateness of this test is demonstrated in *Harding v. United States*, 113 F.Supp. 461 (Ct. Cl. 1953), a case in which the Commissioner allowed the taxpayer's deduction of a bad debt as a business debt, but disallowed the taxpayer's attempt to include the deduction in his net operating loss deduction. In

holding that the taxpayer should be allowed to carry-back the bad debt, the Court commented:

> It is difficult to see how Plaintiff could be entitled to the deduction of this bad debt from his income in 1946 as a loss incurred in his business, as the Commissioner of Internal Revenue held, and not be entitled to deduct it in computing his loss for carry-back purposes, since all that Plaintiff need show to be entitled to the carry-back is that the loan which became a bad debt was "attributable to the operation" of his trade or business.

Id. at 463.

This comment is of significant impact on the present problem. It is of help in determining or at least placing some parameters on the meaning of the §172(d)(4) phrase "attributable to a taxpayer's trade or business" other than whether the expenditures were related to taxpayer's trade or business.

Certainly it was intended and must be concluded that if, for purposes of §166(d), a bad debt is classified as *not* a non-business bad debt, then such deduction must also be entitled to be treated as "attributable to a taxpayer's trade or business" under §172(d)(4). *Harding v. United States*, 113 F.Supp. at 463. Thus, the test under §172(d)(4) must be no more stringent than the test imposed to determine whether an expenditure qualifies as a business bad debt. Because §172(d)(4) imposed a *single* test to measure all deductions allowable under Chapter 10 of the Internal Revenue Code of 1954, *Tompkins v. United*

States, 461 F.2d 1304, 1309-1310 (Ct. Cl. 1972), it cannot be said that deductions under §166 must be tested under a different criteria than deductions under §163 for purposes of the net operating loss deduction. Therefore, although the test imposed by §172(d)(4) may not be at this point defined with 100% accuracy, it would be sufficient in this case to impose the test advanced with respect to expenditures under §166(d), because §172(d)(4) can be no more restrictive.

The Supreme Court imposed the "dominant motivation" approach in its determination of whether a bad debt is a business bad debt in a case involving an employee-shareholder. Because this case involves a partner, Petitioner submits that the "significant motivation" approach is appropriate. To view the investment motivation of a partner in his partnership as comparable to the investment motivation of an employee-shareholder, is to ignore a basic distinction between partnerships and corporations, i.e. personal liability and freely transferable interests. Furthermore, as in this case, the partnership business was the Petitioner's business — the business to which he devoted most of his time and derived most of his income. Thus, Petitioner's motivation need not face the strict inquisition it would were he an employee-shareholder rather than a partner. As discussed *infra*, even though Petitioner's sole and dominant motivation attached to considerations of his business livelihood, as opposed to the investment potential of his partnership interest, and thus would satisfy the dominant moti-

vation approach, the more appropriate test would be whether his business motivation was significant.

The test imposed by the Supreme Court under §166 (d) on facts involving an employee-shareholder is the "dominant motivation" approach. This approach, "is consistent with the mandate of Section 262 of the Code . . ., is consistent with that approach given the loss provisions in Section 165(c)(1) . . . and in Section 165(c)(2). In these related areas, consistency is desirable." *United States v. Generes*, 405 U.S. 93, 104, 105 (1972). Petitioner submits that consistency is unnecessary to §172(d)(4) in this case, but even so, Petitioner herein meets such test.

Under the dominant motivation test, the question becomes whether the taxpayer's dominant motivation in making the payment on the sum out of which the interest became payable was to protect (1) his trade or business, or (2) his investment in the partnership. This test is entirely within the mind of the taxpayer. Contrary to the lower Courts' analysis, outside influences and factors do not have an absolute make-or-break impact on the determination, although they may be taken as evidence of the taxpayer's motivation. *United States v. Generes*, 405 U.S. 93 (1972). Here, Petitioner is a partner, much closer to sole proprietor than employee-shareholder. In any event, Petitioner purchased the partnership interest in question here motivated solely, signficantly, and dominantly by business considerations. Inasmuch as Petitioner qualifies under either the significant motivation or the dominant motivation approach, the interest payments in question were attributable to Petitioner's trade or business.

Again, insisting *Axelrod* controls, in the event that *Five Star Manufacturing Corp. v. Commissioner*, 355 F.2d 724 (5th Cir. 1966) and *United States v. Smith*, 418 F.2d 589 (5th Cir. 1969) are deemed to be relevant, and since *Jim Walter Corp.* limits *Smith* and *Five Star* to allowing a deduction only in situations where a payment to purchase a capital asset, though capital in nature, is necessary to the taxpayer's survival, it is submitted that the facts in this case meet the test for deductibility set forth in *Jim Walter Corp.* for the application of *Five Star* and *Smith*. Much is made by the District Court that the emergency must be dire, in the nature of a threat of suit for accounting and dissolution as in *Axelrod*. Memo. Op. *infra*, p. 27. Furthermore, the District Court admits (Memo. Op. *infra*, p. 30) that the agreement between Payte, Krauss and Baker was a method to avoid *automatic* dissolution under Texas law. To say that if one plans to avoid catastrophy in his business the interest expense thereby incurred is less attributable to his trade or business than one who, without planning, stumbles into catastrophy is more than ludicrous. The situations should be, from a tax standpoint, identical. The outside force present here, if one is required, is the automatic dissolution required by Texas law in the absence of the sort of agreement for orderly liquidation of a deceased partner's interest as is present in this case. The primary reason for entering into the Buy-Sell Agreement was the survival of Petitioner and the partnership. Such an arrangement was essential to the

survival of the partnership and therefore the interest payments in question are deductible under the rationale of both *Five Star* and *Smith*.

PRAYER

Wherefore, for the reasons set forth herein, Petitioner prays that this Honorable Court grant this Petition and that a Writ of Certiorari issue to review this cause.

Respectfully submitted,

DANIEL L. PENNER
PENNER & JONES
1400 Fort Worth National Bank Bldg.
Fort Worth, Texas 76102
Counsel For Petitioner

CERTIFICATE OF SERVICE

I, Daniel L. Penner, attorney for Samuel G. Payte, Petitioner, and a member of the Bar of the Supreme Court of the United States, hereby certify that three (3) copies of the foregoing Petition for Writ of Certiorari have been sent to the Solicitor General of the United States, Department of Justice, Washington, D.C. 20530, attorney for Respondent United States, by depositing same in the United States Mail, first-class postage prepaid, this 17th day of December, 1980.

DANIEL L. PENNER

Appendix

PER CURIAM OPINION
626 FEDERAL REPORTER, 2d SERIES 400

Samuel G. PAYTE, Plaintiff-Appellant,

v.

UNITED STATES of America, Defendant-Appellee.

No. 79-1601.

United States Court of Appeals,
Fifth Circuit.

Sept. 24, 1980

Before GOLDBERG, TATE and SAM D. JOHNSON, Circuit Judges.

PER CURIAM:

The taxpayer filed suit seeking a refund of assessed tax liability in the amount of $16,546.90, with additional interest of $3,242.97 and a penalty of $918.13. The district court granted the government's motion for summary judgment, and the taxpayer appeals.

The taxpayer attempted to carry back certain 1971 interest deductions to offset his 1968 tax liability for business income. However, under § 172(d)(4) of the Internal Revenue Code of 1954, 26 U.S.C. § 172(d)(4), only deductions "attributable to a taxpayer's trade or business" may be carried back to offset business income. The issue in this case is whether interest paid by the taxpayer on a promissory note is "attributable to [the] taxpayer's trade or business." Pursuant to an agreement between the partners in 1968, the proceeds of the promissory note were used to purchase

the partnership interest of a deceased business partner, following his death in 1969. We hold that interest paid in such circumstances is not attributable to a taxpayer's trade or business within the meaning of § 172 (d) (4).

AFFIRMED on the basis of the district court's opinion, 492 F.Supp. 518 (N.D.Tex. 1979).

Appendix

MEMORANDUM OPINION
492 FEDERAL SUPPLEMENT 518

CIVIL ACTION NO. CA 4-76-344

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF TEXAS
FORT WORTH DIVISION

SAMUEL G. PAYTE
PLAINTIFF

VS.

UNITED STATES OF AMERICA
DEFENDANT

MEMORANDUM OPINION

This lawsuit is a civil action for the refund of Federal income taxes pursuant to 28 U.S.C. § 1346(a)(1). The case is before the Court on cross-motions for summary judgment.

Plaintiff Samuel Payte was involved in two business partnerships with E. L. Baker and Irwin Krauss which dealt in real estate joint ventures for the development of commercial and residential property. In 1968 the plaintiff and his two business partners executed an agreement among themselves that in the event of the death of one of the partners, the two surviving partners would purchase the deceased partner's interest. The terms of this 1968 agreement among the partners provided for a downpayment of ten percent of the value of the deceased partner's interest and the execution of a six year promissory note for the balance. The note was to bear interest at the rate of four

percent per year and was to be secured by property belonging to the joint venture.

In November 1969 E. L. Baker of the partnership died. Plaintiff and Mr. Irwin Krauss as the surviving partners appraised the value of the decedent partner's interest at $1,364,336.92. In accordance with the 1968 agreement, surviving partners Payte and Krauss made a cash payment of $136,426.92 and in February 1970 executed a six year promissory note for $1,227,900 at four percent per annum on the unpaid balance to the Fort Worth National Bank, trustee for the Baker Estate.

In 1971 plaintiff Payte paid the Fort Worth National Bank, trustee for the estate of the deceased partner, the sum of $83,464.00 of which $24,038.64 was interest on the promissory note.

Subsequently on his 1971 income tax return plaintiff claimed the interest expense as an itemized deduction. The interest expense was treated as being attributable to trade or business and as allowed by Section 172 of the Internal Revenue Code was carried back to offset plaintiff's 1968 tax liability for business income. Based on this 1971 carryback to 1968, plaintiff in 1972 received a refund of $16,813.61 plus interest of $567.67.

Subsequently plaintiff's carryback was audited and in 1975 plaintiff was assessed tax liability for 1968 of $16,546.90, with additional interest of $3,242.97 and a penalty of $918.13. It is this sum of $20,708.00 which is in controversy.

The tax question before this Court is whether the interest paid by the plaintiff on the promissory note,

the proceeds of which were paid to the deceased partner's estate for the purchase of partnership interest, should be characterized as attributable to plaintiff's trade or business, and therefore deductible; or characterized as an interest expense resulting from the acquisition of a capital investment and not fully deductible.

Plaintiff Payte's position places great importance on the case of *Axelrod v. Commissioner*, 320 F.2d 327 (6th Cir. 1963) in which it was held that the acquisition of capital interest in a partnership so that the existence of the business enterprise might be preserved may be favorably compared for business expense tax purposes to either the acquisition of assets by the business for inventory or to property acquisition for income production.

The focal point of plaintiff's position is that the purchase of the deceased partner's interest pursuant to the 1968 agreement was essential to preserve the going noncorporate business of the partnership. Clearly in the *Axelrod* case the purchase of the partnership interest was essential to preserve the going noncorporate business because one of two partners in the business partnership in that case had notified the sole other partner that unless the partnership interest was purchased, litigation would be instituted for dissolution of the partnership and an accounting.

The briefs filed by plaintiff in this case reflect that the reason that the three partners entered into the 1968 agreement was to provide that the family or heirs of a deceased partner would not become involved in the actual business operations of the partnership, and to assure payment of partnership indebtedness.

It is plaintiff's assertion that without the 1968 agreement and the 1970 execution of the promissory note the partnership would upon the death of a partner have been forced to liquidate. The touchstone of plaintiff's position is the characterization of the 1968 agreement's purpose as essential to the continuation of the business. Considerable emphasis is placed by plaintiff on the fact that the purchase by the surviving partners of the deceased partner's interest was a purchase of interest in a going business in which Payte had a present and continuing interest in preserving the existence of the business. This fact does distinguish Payte's purchase of partnership interest from those cases which disallowed deductions by specifically distinguishing *Axelrod, supra. See Robert E. Imel,* 61 T.C. 318 (1973); *William K. Coors,* 60 T.C. 368 (1973); *Frank J. Saia,* ¶ 74, 300 P-H Memo TC (1970). These cases distinguish *Axelrod, supra* on the basis that a central feature of *Axelrod, supra* is that the claimed expenses were for the purchase of interest in the claimant's own ongoing business. The expense in question in order to qualify for deduction must be attributable to the taxpayer's trade or business operations. *Harding v. United States,* 113 F. Supp. 461 (Ct. Cl. 1953).

However, the key question in order to properly analogize an expense to that of *Axelrod, supra* is whether the expense is essential to the very continuing existence of the business itself. Clearly in *Axelrod, supra* with the threat of litigation for dissolution and accounting, the continued existence of the business was in question. It is this analysis which has been taken by the United States Court of Appeals for the Fifth Circuit. *See Five Star Manufacturing Co. v. Commis-*

sioner of Internal Revenue, 355 F.2d 724 (5th Cir. 1966); *United States v. Smith*, 418 F.2d 589 (5th Cir. 1969); *Jim Walter Corp. v. United States*, 498 F.2d 631 (5th Cir. 1974).

In commenting on *Five Star Manufacturing Co.*, *supra* and *United States v. Smith*, *supra*, Judge Tuttle pointed out in the *Jim Walter Corp.* case the nature of the business emergency analysis,

> . . . The expenditure in those two cases were made to save the corporation from dire and threatening consequences. The court in *Five Star* stressed the extraordinary factual situation which showed a business emergency. Similarly the district court in *Smith* found that the corporation paid the liability in order to save its business and therefore the payment was a noncapital expenditure. In the instant case no similar emergency business purpose was presented; in fact, the district court expressly pointed out that the corporation was prospering. We think the principal followed in the two cited cases should not be extended beyond the facts of the cases.

Jim Walter Corp., *supra* at 639. In his analysis Judge Tuttle also stated,

> . . . [W]e cannot accept appellant taxpayer's argument that *Five Star* and *Smith* set forth any broad principle that if an expense of recapitalization or other capital structure reformation serves a business purpose other than the acquisition of property it is deductible, even though it may appear to be or in fact is, a part of a capital transaction. Rather, we read *Smith* and *Five*

> *Star* as being limited to situations where a payment to purchase a capital asset, though capital in nature, is necessary to the taxpayer's survival. *See* H. and G. Industries, Inc. v. C.I.R., 3rd Cir. 495 F.2d 653 (1974).

Jim Walter Corp., supra at 639.

Plaintiff Payte in an initial memorandum cited the allowed deduction in *Five Star Manufacturing Co., supra* as supporting his posiiton [sic]. In a subsequent supplemental memorandum paintiff has contended that the analysis of *Five Star Manufacturing Co., supra* and its subsequent limitation by *Jim Walter Corp., supra* are inapplicable to plaintiff's situation since those cases concern corporate acquisitions rather than the acquisition of additional partnership interest. This Court finds this distinction by plaintiff to be without merit.

The focus of this Court in determining the deductibility of plaintiff's claim is an analysis of the origin and character of the claim. The United States Supreme Court has stated:

> [The] origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test of whether the expense was a 'business' or 'personal' and hence whether it is deductible or not . . .

United States v. Gilmore, 372 U.S. 39, 83 S.Ct. 623, 9 L.Ed.2d 570 (1963). It is this origin and character analysis that guided the courts in *Harder Services, Inc. v. Commissioner*, 67 T.C. 585 (1976); *Jim Wal-*

ter Corp., supra; and *Estate of Meade v. Commissioner*, 489 F.2d 161 (5th Cir. 1974). As the test states, if the expense was 'business' plaintiff Payte is entitled to his deduction. In the alternative, "It has long been recognized, as a general matter, that costs incurred in the acquisition or disposition of a capital asset are to be treated as capital expenditures." *Woodward v. C.I.R.*, 397 U.S. 572, 90 S. Ct. 1302, 25 L.Ed. 2d 577 (1970).

Plaintiff contends that the purchase of the deceased partner's interest in the partnership pursuant to the 1968 agreement was to effect the preservation of the existence of the partnership and was necessary to the survival of the business. It is true that as a matter of law under the Texas Uniform Partnership Act § 31(d)(4) the death of a partner will create the dissolution of a partnership *unless* (emphasis supplied) the agreement between the partners provides otherwise. Indeed the 1968 agreement between the partners was a method to avoid dissolution. However, this Court finds that the purchase of the deceased partner's interest cannot be characterized as essential to the survival of the partnership. The terms of the 1968 agreement and the subsequent purchase were motivated by the financial, personal, and business planning among the partners. The expense was not dictated by outside forces directly threatening the business partnership's survival, and thus the facts are not analogous to *Axelrod, supra* or to *Five Star Corp., supra. See Harder Services, Inc. v. Commissioner, supra* at 596. The origin and character of the claim to which the expense was incurred was the 1968 agreement entered into so that the family or heirs of a deceased partner would not become involved in the actual busi-

ness operations of the partnership. As such plaintiff's acquisition of the partnership interest though based on a business consideration was an acquisition of a capital asset for which the disallowance of the business deduction was proper. Accordingly, we conclude that plaintiff is not entitled to deduct the interest claimed as a business expense.

It is, therefore, ORDERED that plaintiff's Motion for Summary Judgment be denied, and that defendant's Motion for Summary Judgment be granted.

Judgment will be entered accordingly.

Signed this 8th day of January, 1979.

/s/ Eldon B. Mahon
UNITED STATES DISTRICT JUDGE

Appendix

JUDGMENT SOUGHT TO BE REVIEWED

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 79-1601

D. C. Docket No. CA 4-76-344

SAMUEL G. PAYTE, Plaintiff-Appellant,
versus

UNITED STATES OF AMERICA,
Defendant-Appellee.

Appeal from the United States District Court for the Northern District of Texas

Before GOLDBERG, TATE and SAM D. JOHNSON, Circuit Judges.

JUDGMENT

This cause came on to be heard on the transcript of the record from the United States District Court for the Northern District of Texas, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby, affirmed;

It is further ordered that plaintiff-appellant pay to the defendant-appellee the costs on appeal, to be taxed by the Clerk of this Court.

September 24, 1980

Issued as Mandate: OCT. 16, 1980

Appendix

JUDGMENT OF THE DISTRICT COURT

CIVIL ACTION NO. CA 4-76-344

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF TEXAS
FORT WORTH DIVISION

SAMUEL G. PAYTE
PLAINTIFF
VS.

UNITED STATES OF AMERICA
DEFENDANT

JUDGMENT

This action came on for hearing before the Court, Honorable Eldon B. Mahon, District Judge, presiding, and the issues having been duly hearing [sic] and a decision having been duly rendered, it is ORDERED and ADJUDGED that the plaintiff Samuel G. Payte take nothing, that the action be dismissed on the merits and that each party is to bear its own costs of action.

Signed this 8 day of January, 1979.

/s/ Eldon B. Mahon
UNITED STATES DISTRICT JUDGE

No. 80-1000

FEB 24 1981
ALEXANDER L. STEVAS
CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1980

SAMUEL G. PAYTE, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

WADE H. MCCREE, JR.
Solicitor General
Department of Justice
Washington, D.C. 20534
(202) 633-2217

TABLE OF AUTHORITIES

Page

Cases:

Axelrod v. *Commissioner*, 320 F. 2d 327 3

United States v. *Generes*, 405 U.S. 93 3

United States v. *Gilmore*, 372 U.S. 39 4

United States v. *Hilton Hotels, Corp.*, 397 U.S. 580 3

Whipple v. *Commissioner*, 373 U.S. 193 3

Woodward v. *Commissioner*, 397 U.S. 572 3

Statutes:

Internal Revenue Code of 1954 (26 U.S.C.):

Section 163 2

Section 166(d)(2) 3

Section 172(d)(4) 1, 2

In the Supreme Court of the United States

OCTOBER TERM, 1980

No. 80-1000

SAMUEL G. PAYTE, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

Petitioner seeks review of the decision in this federal income tax case holding that interest paid on a loan incurred to purchase his deceased partner's partnership interest did not qualify for net operating loss carryback treatment because the underlying loan transaction was not attributable to his trade or business within the meaning of Section 172(d)(4) of the Internal Revenue Code of 1954 (26 U.S.C.).

1. The pertinent facts are as follows: In 1968, petitioner, a member of a three-man partnership, entered into a buy-sell agreement with his partners providing that the surviving partners would purchase a deceased partner's interest (Pet. App. 24). In 1969, one partner died, and the surviving partners, in accordance with the agreement, had the decedent's partnership interest appraised. They made a down payment of ten percent of the purchase price, executing a

six-year promissory note carrying interest at four percent per annum on the unpaid balance, payable to the trustee of the deceased partner's estate. In 1971, petitioner paid to the trustee $83,464, of which $24,038.64 was interest. On his 1971 income tax return, petitioner claimed the interest expense as an itemized deduction, and, treating the transaction as attributable to his trade or business, attempted to carry back the interest deduction not consumed in 1971 to 1968, reducing his tax liability for that earlier year. On audit, the Commissioner disallowed petitioner's claimed carryback loss and determined a deficiency (Pet. App. 25).

Petitioner paid the assessment and brought this suit for refund in the United States District Court for the Northern District of Texas. The district court upheld the Commissioner's disallowance on the ground that petitioner's acquisition of the partnership interest was not attributable to his trade or business, but was an acquisition of a capital asset (Pet. App. 31). The court of appeals affirmed *per curiam*, on the basis of the district court's opinion (Pet. App. 22-23).

2. The decision below correctly held that petitioner could not carry back the unused portion of his 1971 interest deduction to 1968. This case does not involve the deductibility of interest as such. Interest is deductible under Section 163 of the Code if paid or incurred on business or personal loans. This case arises, however, in the context of the net operating loss carryback. In 1971, petitioner's interest deductions exceeded his income, so that he would lose the benefit of that interest deduction unless it could be carried back to offset income of an earlier year. To qualify for carryback treatment under the net operating loss provision of Section 172(d)(4), the interest must be attributable to petitioner's trade or business; interest paid on a nonbusiness loan may not be carried back to a previous taxable year. The decision below correctly held that the interest, which was an integral part of the cost of acquiring the deceased

partner's share, was not attributable to petitioner's trade or business, but was attributable to the acquisition of a capital asset (Pet. App. 30-31). *United States* v. *Hilton Hotels Corp.*, 397 U.S. 580 (1970); & *Woodward* v. *Commissioner*, 397 U.S. 572 (1970). Petitioner's argument (Pet. 9-13) that his significant and/or dominant motivation in making the payment was to preserve the business from termination or forced sale is beside the point. In this context, petitioner was acting as an investor, which does not constitute a trade or business.

Axelrod v. *Commissioner*, 320 F 2d 327 (6th Cir. 1963), upon which petitioner relies (Pet. 15, 20), is distinguishable on its facts. In *Axelrod*, the court held that the phrase "trade or business" as used in Section 166(f) of the Code (dealing with bad debt losses arising from guarantees) was broad enough to cover the borrower's acquisition of a capital interest in a going partnership in order to preserve its existence. As the district court correctly noted (Pet. App. 27, 30), the decision in *Axelrod* turned on the fact that the taxpayer's purchase of the interest was essential to the preservation of the partnership because outside forces were directly threatening its survival. Here, on the other hand, the district court found that the survival of the partnership was not an issue. Moreover, petitioner's purchase of the interest was not essential to the preservation of the partnership. There was accordingly no trade or business nexus with that purchase.

At all events, the decision below is in accord with *United States* v. *Generes*, 405 U.S. 93 (1972), and *Whipple* v. *Commissioner*, 373 U.S. 193 (1963). *Generes* and *Whipple* each held that a loan made to a taxpayer to protect his investment is not one incurred in connection with his "trade or business" for purposes of a business bad debt deduction under Section 166(d)(2) of the Code. Under *Whipple*, decided two months prior to *Axelrod*, and *Generes*, there is

no basis for petitioner's claim that his purchase was part of his trade or business rather than his investment activities. To the extent *Axelrod* ignores the taxpayer's capital investment and turns on a taxpayer's perceived business preservation motive, it is inconsistent with *Whipple* and *Generes*. See also *United States* v. *Gilmore*, 372 U.S. 39 (1963).[1]

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.
Solicitor General

FEBRUARY 1981

---

[1]Finally, petitioner contends (Pet. 12-16) that his case involves a partnership and not a corporation so that his activities cannot be characterized as capital investment. But it is immaterial whether the business was conducted as a three-man partnership or three-man corporation. In either event, petitioner increased his capital interest, *i.e.*, investment in the business, whether he bought shares of a corporation or a partnership interest from the decedent's estate.